United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-4170

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

EDWARD M. GILBERT,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly determined that taxpayer's unauthorized withdrawals of funds from E.L. Bruce Co., Inc. during 1962 represented income to taxpayer.

STATEMENT OF THE CASE

Edward M. Gilbert (taxpayer) appeals from the United States Tax Court's decision that a federal income tax deficiency is due from him for the year 1962 in the amount of $1,467,536.51. (R. 205-A.)[1/] The memorandum findings of fact and opinion of the Tax Court (Judge Quealy) are reported at P-H Memo T.C., par. 76,104. (R. 187-A--204-A.) Taxpayer's notice of appeal was timely filed on June 30, 1976. (R. 3-A.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts, as found by the Tax Court, are summarized as follows:

Taxpayer resided in New York, New York, at the time he filed his petition to the Tax Court. During the relevant period, he was a cash basis taxpayer. (R. 188-A, 189-A.)

From September, 1958, until June 12, 1962, taxpayer was first chairman of the Executive Committee and later president, the principle executive officer and a director of E.L. Bruce Co., Inc. (Bruce Co.) and its predecessor corporations, which were engaged in the lumber supply business. During this period, taxpayer was also the major stockholder of Bruce Co. and the principal executive officer of Rhodes Enterprises, Inc. (Rhodes), all

1/ "R." references are to the separately bound record appendix.

of whose issued and outstanding stock he beneficially owned. Taxpayer also beneficially owned and controlled the Empire Hardwood Flooring Corporation. (R. 189-A.)

In 1961 and 1962, taxpayer personally and through Rhodes undertook the purchase of a large number of shares of the Celotex Corporation (Celotex). All such stock acquired by taxpayer and Rhodes was purchased on margin. Taxpayer pledged all of his Bruce Co. stock as collateral for loans to purchase the Celotex stock. (R. 190-A.)

At the regular meetings of Bruce Co.'s board of directors on January 8, 1962, and March 5, 1962, taxpayer informed the other directors that he had purchased, or expected to purchase, a substantial amount of Celotex stock; that he believed a merger of Celotex with Bruce Co. would be in the best interests of Bruce Co.; and that he believed a large block of Celotex stock was in the hands of persons who would favor such a merger. He further offered to make any of his own Celotex holdings available to Bruce Co. at cost. Pursuant to these recommendations, the board on March 5, 1962, passed a resolution authorizing Bruce Co.'s chairman, president, or executive vice-president to expend up to $400,000 of the company's funds for the purchase of Celotex stock, and to make various

inquiries regarding a possible merger of the two corporations. On April 17, 1962, the board increased the amount of authorized funds to $1,000,000. (R. 190-A--192-A.)

As a result of these authorizations, Bruce Co. itself purchased a substantial amount of Celotex stock. Taxpayer also induced his friends and associates to purchase Celotex stock, guaranteeing them against loss, and by the end of May, 1962, Bruce Co., taxpayer and his associates had 56 percent of Celotex' outstanding stock in hand and available for the merger. Negotiations for the merger had proceeded to the point in late May where it was agreed that certain directors of Bruce Co. would be placed on the board of Celotex. (R. 193-A.)

In late April, 1962, taxpayer went to Nevada to establish a residence in order to obtain a divorce. During the latter part of May, 1962, while taxpayer was still in Nevada, there was a severe decline in the price of both Bruce Co. and Celotex stock. Because of the decline, taxpayer was called upon to furnish additional margin for the Celotex stock purchased by him and his associates. (R. 193-A.)

Ostensibly to provide funds to meet these margin calls, taxpayer caused Irwin Polivy, Bruce Co.'s secretary, to draw a series of checks totaling $1,958,000 on the account of Bruce Co., payable to Rhodes or to

Empire Hardwood Flooring Corporation. On June 5, 1962, Empire Hardwood repaid $5,000 of this amount. (R. 194-A.)

On June 8, 1962, taxpayer went to the offices of Shearman, Sterling and Wright, who were counsel for Bruce Co. at the time. Robert N. West, a partner in the firm, prepared and taxpayer executed promissory notes totaling $1,953,000, along with an assignment to Bruce Co. of all taxpayer's property. The promissory notes were predated to coincide with the dates of the unauthorized withdrawals. The assignment was predated May 28, 1962, and included cash in banks, stocks and other investments, real estate, paintings and other art objects, a stamp collection and various "participations". The fair market value of the property assigned by taxpayer to secure the promissory notes exceeded the face amount of the notes on June 8, 1962 and on June 12, 1962. (R. 194-A--195-A.)

During this period, taxpayer also initiated negotiations to sell the Celotex stock held by Bruce Co., taxpayer and Rhodes to the Ruberoid Company. A meeting of the board of directors of Ruberiod was called for June 12, 1962, in order to consider the purchase. (R. 194-A.)

A special meeting of the board of directors of Bruce Co. was held on June 12, 1962. At the meeting, West informed the board that taxpayer had made or caused to

be made unauthorized withdrawals from Bruce Co. totaling $1,953,000, and described the circumstances leading up to the withdrawals and the manner in which they had been made. West also reported the negotiations with Ruberoid Company for the sale of the Celotex stock at a price of $36 per share, but informed the board that this offer of sale had been rejected by Ruberoid. The board then requested and received the resignations of taxpayer and Polivy. The board further instructed taxpayer to continue his negotiations for the sale of the Celotex stock and to report back later that day. It additionally directed the proper corporate officers to notify the Securities and Exchange Commission and the American Stock Exchange of the disclosures made at the meeting, and authorized a statement to be released for publication regarding taxpayer's unauthorized withdrawals and resignation. Finally, it authorized counsel for the corporation to take any and all legal action which counsel deemed appropriate, including the bringing of legal action against taxpayer. (R. 195-A--197-A.)

As a result of what transpired at the meeting of June 12, 1962, including the threat of possible criminal prosecution, taxpayer flew to Brazil that evening. Because of the announcement of the unauthorized withdrawals and

taxpayer's flight to Brazil, the market price of Bruce Co. stock sharply declined. The stock had opened on the American Stock Exchange at $19 per share and traded at a high of $20 per share. It thereafter traded as low as $14.75 per share and closed at $15.75 per share. On the following day (June 13), prior to the suspension of trading, it was trading at $10 to $10.50 per share. The stock of Celotex was also adversely affected. As a result, the Bruce Co. and Celotex stock owned by taxpayer and held as collateral or in margin accounts was sold. Neither Bruce Co. nor taxpayer realized any funds from such sales. (R. 197-A--198-A.)

On June 13 or June 14, 1962, Bruce Co. attempted to file taxpayer's assignment. The company was informed that there would be a filing fee of between $10,000 and $15,000 for the mortgage recording tax because real estate was included in the assignment. Bruce Co. chose not to pay the filing fee, and accordingly, did not file the assignment. (R. 198-A.)

Notices of federal tax liens in the sum of $3,341,743.95 were filed on June 22, 1962, with respect to the income tax liabilities of taxpayer and his wife for the taxable years 1958, 1959, 1960 and 1962. These liens were filed

with respect to joint jeopardy assessments for income taxes made against taxpayer and his wife for the years 1958, 1959 and 1960 in the respective amounts of $3,836.40, $1,119,164.80 and $494,986.20. Also, a joint assessment was made on June 25, 1962, in the amount of $1,723,776.[2/] (R. 198-A.)

During the first week of November, 1962, taxpayer returned from Brazil to New York. On November 5, 1962, acknowledging an indebtedness to Bruce Co. of $1,953,000, he executed a second assignment, this time omitting real property. On November 27, 1962, a consent judgment in favor of Bruce Co. in the sum of $1,953,000 plus interest was entered against taxpayer. (R. 198-A--199-A.)

On September 25, 1964, taxpayer pleaded guilty to three counts of an indictment filed in the United States District Court for the Southern District of New York. The counts to which he pleaded guilty charged taxpayer with devising a scheme to defraud and to obtain money by means of false and fraudulent pretenses, representations and promises from Bruce Co.,in the amount of $1,953,000; with transporting and causing to be transported in foreign commerce from New York to Paris, France, securities and monies of a value in excess of $5,000, knowing the same to have been stolen, converted and taken by fraud; and, with failing to file with the American Stock Exchange and the Securities and Exchange Commission a statement indicating taxpayer's beneficial ownership in Bruce Co. and changes therein for the month of May, 1962. (R. 199-A.)

2/ The 1958 assessment has been paid in full. The 1959 and 1960 deficiencies and penalty, as determined by the Tax Court, have been paid.

On February 2, 1967, taxpayer pleaded guilty to three counts of an indictment for grand larceny filed against him by a New York County grand jury. The counts to which taxpayer pleaded guilty charged that on three separate dates in May and June of 1962, taxpayer, "with intent to deprive and defraud another of property, and of the use and benefit thereof, and to appropriate the same to his own use, and to the use of someone other than the true owner, stole property from E.L. Bruce Co. (Incorporated)" in the amounts of $340,000, $490,000, and $287,000. (R. 199-A--200-A.)

For the fiscal year ended June 30, 1962, Bruce Co. claimed a loss deduction on its books and records which included the unauthorized withdrawals of $1,953,000. (R. 200-A.)

On these facts, the Tax Court determined (R. 201-A.) that taxpayer realized income during his taxable year 1962 to the extent of his unauthorized withdrawals from Bruce Co. The Tax Court further determined (R. 201-A--204-A.) that taxpayer's execution of the promissory notes secured by assignments of all of his property to Bruce Co. did not constitute actual repayment of the withdrawn funds, and consequently, taxpayer was not entitled to any deduction for restitution made during his taxable year 1962. From the decision[4] based on these determinations, taxpayer appeals.

3/ Taxpayer was also involved in a number of other legal proceedings during this period. See, e.g., Sarlie v. E.L. Bruce Co., 265 F. Supp. 371 (S.D. N.Y., 1967).

4/ The Commissioner's deficiency determination for taxpayer's 1962 tax year included the disallowance of certain relatively minor deductions for interest and taxes. Taxpayer did not contest these items before the Tax Court.

SUMMARY OF ARGUMENT

Taxpayer appeals from a decision of the Tax Court that a deficiency is due from taxpayer for the year 1962 in the sum of $1,467,536.51. The deficiency resulted from taxpayer's misappropriation of $1,953,000 from the Bruce Co. during that year. The issue on appeal is whether the Tax Court correctly determined that such misappropriations constituted taxable income to taxpayer for his taxable year 1962. We submit that the Tax Court's resolution of this issue was correct and should be affirmed.

In *James* v. *United States*, 366 U.S. 213 (1961), the Supreme Court determined that under the long-established criteria of dominion, control and economic benefit, the proceeds of an embezzlement constitute taxable income to the embezzler. The Court found, p. 219, that when a taxpayer acquires earnings, either lawfully or unlawfully, "without the consensual recognition * * * of an obligation to repay", he has realized taxable income even if he may be required to restore the money at a later date. In the present case, taxpayer pleaded guilty to three counts of an indictment for grand larceny of Bruce Co. funds. Therefore, the facts that taxpayer misappropriated money from Bruce Co.,

that he exercised dominion and control over it, and that he realized the economic benefits of ownership, are unassailable. In view of these facts, and under the holding in James, taxpayer clearly realized taxable income as a result of his misappropriation of Bruce Co. funds.

.Nonetheless, taxpayer argues that because he executed secured promissory notes in the amount of the withdrawals within several days after the withdrawals, and because he voluntarily informed Bruce Co.'s board of directors of his actions within a week of their occurence, there existed between Bruce Co. and taxpayer a "consensual recognition" of taxpayer's obligation to repay. Accordingly, it is contended that taxpayer could not have realized taxable income within the meaning of James.

This argument, however, misconstrues the meaning of the phrase "consensual recognition * * * of an obligation to repay". Such "consensual recognition", we submit, can arise only at the time when funds are actually transferred, and therefore signifies nothing more than a common loan transaction. Unlike a loan, however, an embezzlement occurs without the knowledge or consent of the rightful owner of the embezzled funds. Accordingly, there can be no "consensual recognition" at the time of the embezzlement. Nor does the embezzler's subsequent admission of guilt,

or the victim's subsequent recognition of a right to repayment, relate back to the time of the wrongful act. The law itself imposes upon the embezzler an obligation to repay from the time of the embezzlement. Recognition of that obligation by either the embezzler or his victim after the embezzlement has been discovered or admitted changes nothing and adds nothing to the act of embezzlement itself. Such recognition cannot alter the character of the original receipt from income to something else.

The only relief available to taxpayer with respect to his taxable year 1962 was to repay the misappropriated funds and deduct from his income the amount of repayment. Taxpayer concedes that his tender of secured promissory notes to Bruce Co. in June of 1962 did not constitute actual repayment in that year, and that Bruce Co. did not accept his assignment of property as payment for its claim against him. Accordingly, the Tax Court correctly determined that taxpayer did not make any deductible restitution in 1962.

Nonetheless, taxpayer argues that the Government's filing of liens on his property prevented repayment, and therefore he should not be deemed as having received taxable income from the embezzlement. However, it is clear that the Government's actions were motivated, at least in part, by taxpayer's own decision to flee to Brazil. Moreoever, there is no indication in the evidence adduced at trial that at the time of his return from Brazil, taxpayer attempted to

negotiate the release of the Government's liens so that he could make restitution to Bruce Co. Indeed, it was Bruce Co., taxpayer's victim, which ultimately worked out an agreement with the Government under which Bruce Co. could realize some recovery on the assignment. And it is to be noted that some degree of the Bruce Co.'s difficulties in this regard stems from its unwillingness to pay the filing fee which was required in order to record taxpayer's assignment. Under these circumstances, it is somewhat misleading to fault the Government for filing tax liens so that its tax position would not be jeopardized.

ARGUMENT

THE TAX COURT CORRECTLY DETERMINED THAT TAX-PAYER'S UNAUTHORIZED WITHDRAWALS WERE INCLUDABLE IN TAXPAYER'S INCOME FOR 1962

The fundamental issue in the present case is whether the unauthorized withdrawals of funds by taxpayer from Bruce Co. during May and June of 1962 constituted taxable income to the taxpayer for that year. We submit that the Tax Court was correct in holding (R. 201-A) that under the doctrine of James v. United States, 366 U.S. 213 (1961), taxpayer is chargeable with having realized income to the extent of his unauthorized withdrawals. As stated by the Supreme Court in James (p. 219):

> When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." North American Oil v. Burnet, supra, at p. 424. In such a case, the taxpayer has "actual command over the property taxed--the actual benefit for which the tax is paid," Corliss v. Bowers, supra. This standard brings wrongful appropriations within the broad sweep of "gross income"; it excludes loans.

In James, the Court applied to all wrongful appropriations the long-established criteria of dominion, control and economic benefit,[5/] fully effectuating the rationale of Rutkin v. United States, 343 U.S. 130 (1952), and repudiating the anomalous exception for embezzled funds, which after Rutkin was the only surviving element of its prior decision in Commissioner v. Wilcox, 327 U.S. 404 (1946).

In the present case, taxpayer does not contest the general rule of James that embezzled funds constitute taxable income to the embezzler. Nor does taxpayer contend that his withdrawals of funds from Bruce Co. were somehow authorized by the corporation. (See Taxpayer's Br., pp. 10-11.) Rather, taxpayer argues (Br. 11) that his unauthorized withdrawals and use of Bruce Co. funds could not give rise to income taxable to him because such withdrawals and use were not undertaken "without the consensual recognition, express or implied, of an obligation to repay" within the meaning of the James case. There is no merit to this contention.[6/]

5/ See, e.g., Corliss v. Bowers, 281 U.S. 376, 378 (1930); Burnet v. Wells, 289 U.S. 670, 678 (1933); Rutkin v. United States, 343 U.S. 130, 137 (1952); and the dissenting opinion in Commissioner v. Wilcox, 327 U.S. 404, 413 (1946).

6/ Taxpayer's "consensual recognition" argument must necessarily be premised upon the characterization of his wrongful withdrawals as "embezzlement," or at least as being closely analogous thereto. Unlike most other situations in which there has been a theft, the embezzler has occupied a position of trust with respect to the misappropriated property, and the transaction is more susceptible of subsequent amendment or characterization by the parties as a loan or advance. By way of contrast, there is almost no likelihood that the victim of larceny or burglary would ever be willing to treat the theft of his property as a loan or advance, and the common thief or burglar would seldom, if ever, have grounds for contending that there had been a "consensual recognition" of an

Clearly, the principal thrust of the James decision is to treat as income money or other property over which the taxpayer has exercised complete dominion and control, and from which the taxpayer has obtained the economic, though not necessarily the legal, benefits of ownership. Thus, James makes it irrelevant, for purposes of determining income versus non-income, whether the money or other property was derived illegally. Because the taxpayer has "the actual benefit for which the tax is paid," he has realized income. As stated by the Court in James, supra, p. 219, it is this standard of control and benefit which "brings wrongful appropriations within the sweep of 'gross income'."

Despite the clarity of these principles, taxpayer apparently contends (Br. 10-23) that the embezzler's receipt of taxable income is somehow nullified if immediately after the unlawful taking there is a mutual recognition by the embezzler and his victim of the embezzler's obligation to repay the misappropriated funds. This argument is founded upon the implication in James, supra, p. 219, that where earnings are acquired with the "consensual recognition * * * of an obligation to repay," such earnings do not constitute taxable income to the recipient. We submit, however, that the very act of embezzlement excludes any possibility of such "consensual recognition," and that this reference

6/ (continued)

obligation to repay. Although for purposes of argument we too have sometimes in this brief treated taxpayer's wrongful withdrawals as embezzlement, it should be noted that in fact taxpayer pleaded guilty to three counts of an indictment charging him with grand larceny. (R. 123-A--129-A.)

in James solely applies to transactions qualifying as loans. Such transactions have never been treated as giving rise to taxable income. See 1 Mertens, Law of Federal Income Taxation (Rev.), § 5.12.

In order for a transaction to qualify as a loan, there must be an understanding between the lender and the borrower, at the time when the money, property, or credit is transferred, that the transaction is to be treated as a loan. "A loan of money is a contract by which one delivers a sum of money to another and the latter agrees to return at a future time a sum equivalent to that which he borrows". In re Grand Union Co., 219 Fed. 353, 356 (C.A. 2, 1915). It is submitted that there is no substantive difference between this definition of the term "loan" and the type of transaction described by the James Court as the receipt of funds with "consensual recognition * * * of an obligation to repay." Both this Court in the Grand Union case and the Supreme Court in James were referring to loans or loan transactions. Moreover, whether such transactions are characterized as "contracts" or "consensual recognitions," it is obvious that any loan agreement necessarily presupposes that the lender has consented to the transfer of money or other property from himself to the borrower.

In contrast to the transactions described above, and notwithstanding taxpayer's assertions to the contrary, it is clear that when funds are taken and used by an embezzler for his own benefit, under no circumstances can there be a "contract" between the embezzler and his victim, or any "consensual recognition * * * of an obligation to repay." The term "embezzlement" necessarily connotes a misappropriation of funds, i.e., a taking of funds without the victim's knowledge or consent. There can be nothing "consensual" about such an act, and accordingly, embezzled funds must always constitute taxable income to the embezzler under the holding in James. Our position in this regard is in full accord with the Tax Court's interpretation of James as stated in Mais v. Commissioner, 51 T.C. 494, 498 (1968):

> We interpret the James case as meaning that any taxpayer who acquires property under circumstances which do not permit the conclusion that the property was received with a consensual recognition, express or implied, of an obligation to repay, and without restriction as to its disposition, is in receipt of taxable income. Certainly in the case of an embezzlement it cannot be considered that the funds are obtained by the embezzler under any consensual recognition of an obligation to repay; indeed, the victim of the embezzlement is unaware of the diversion of his property.

Similarly, in Quinn v. Commissioner, 62 T.C. 223 (1974), aff'd, 524 F. 2d 617 (C.A. 7, 1975), where the chairman of the board of a savings and loan association had misappropriated association funds, but had made partial restitution in the year of withdrawal and had signed a promissory note for the remainder, the Tax Court held, p. 229, that the association had not given its "consensual

recognition" of the transaction as a loan, where the taxpayer had used the funds for his own purposes, where the association's directors had continued to insist on full repayment of the withdrawn funds, and where the taxpayer subsequently had been indicted for misapplying the money. Cf., Norman v. Commissioner, P-H Memo T.C., par. 68,040 (1968), aff'd per curiam, 407 F. 2d 1337 (C.A. 3, 1969), cert. denied, 395 U.S. 947 (1969). Clearly, under these authorities, it is the Commissioner's interpretation of James, and not taxpayer's, which is correct.

In view of the principles set forth above, it makes no difference whether, or when, or for what reason, the embezzler ultimately admits to an obligation to repay his victim. Nor does it matter whether the embezzler "at all times intended to repay the wrongfully withdrawn funds" (Br. 17), or that his admission of an obligation to repay is later evidenced by a promissory note secured by an assignment of all of his property, or by a confession of judgment in favor of his victim. Indeed, the embezzler knows at all times that he is legally obligated to make restitution, and his concession of this when the theft is discovered (or when his conscience moves him to do so) changes and adds nothing to the act of embezzlement itself. Therefore, there is no reason to treat a subsequent concession of the existence of the obligation to repay as somehow relating back and having retroactive effect, or as changing the character of the original receipt of funds from income to something else. As stated by the Seventh Circuit in Quinn v. Commissioner, 524 F. 2d, p. 625:

> * * * once funds are received under a claim of right, they must be included in gross income. A deduction may only be taken when allowed by statute. A cash basis taxpayer's giving of his own note is not sufficient to support a deduction in the year given; it will only support a deduction in the year in which the note is paid. * * * Thus, recognition of the obligation to repay funds received under a claim of right has no tax consequences regardless of whether it occurs in the year the funds were received or a later year.

Nor does the victim's recognition--at the time he discovers the embezzlement--of the embezzler's obligation to repay change in any way the nonconsensual character of the original act. Even in the absence of such recognition by the victim, the law itself at once imposes such a duty to repay upon the embezzler. However, as stated by the Tax Court in Mais v. Commissioner, supra, p. 498, "The Supreme Court [in James] clearly recognized that in the case of an embezzlement the embezzler is in receipt of taxable income despite the fact that the embezzler has an unqualified duty and obligation to repay the money embezzled." In such circumstances, "The only relief available to the embezzler is to deduct from income of any year any amount repaid in such year in restitution." Id. p. 499.

Apart from taxpayer's erroneous legal interpretation of the James case, it is submitted that there is no clear evidence in the record of the "facts" cited by taxpayer in alleged support of his legal propositions. Initially, and although taxpayer does not contest the illegality of his misappropriation of funds from Bruce Co. (Br. 11), it bears repeating that taxpayer pleaded guilty to three counts of an indictment for grand larceny charging that

on three separate dates, taxpayer "with intent to deprive and defraud another of property, and of the use and benefit thereof, and to appropriate the same to his own use, and to the use of someone other than the true owner, stole property from E.L. Bruce Co." in the amounts of $340,000, $490,000, and $287,000. (R. 123-A--129-A.)[7/] It is also important to reiterate that upon learning of the unauthorized withdrawals on June 12, 1962, Bruce Co.'s board of directors refused to ratify them. (R. 82-A--88-A.) Accordingly, the fact of taxpayer's misappropriations is unassailable. As we have argued above, this fact alone required a finding by the Tax Court that taxpayer received taxable income in 1962.

Nevertheless, taxpayer argues that he at all times intended to repay the wrongfully withdrawn funds (Br. 17), and that the withdrawals were made in furtherance of a corporate purpose--the merger of Bruce Co. with Celotex (Br. 11, 17, 22). Although we have already set forth our position that these assertions as to taxpayer's motive and intent, even if true, are irrelevant to the proper determination of this case, we believe that much of the evidence adduced at trial indicates that taxpayer's motives and intentions were more closely attuned to what taxpayer perceived to be his own self-interest, rather than the interests of Bruce Co.

7/ It was stipulated that the total amount of unauthorized withdrawals was $1,958,000, and that $5,000 of this amount was repaid to Bruce Co. on June 5, 1962. (R. 10-A.)

Taxpayer received his margin calls on May 28, 1962, while he was still in Nevada, establishing residence for a divorce. (R. 24-A.) At that time, he called Irwin Polivy, Bruce Co.'s secretary, and instructed him to "pay up the margin calls." (R. 26-A--27-A.) Taxpayer returned to New York on or about June 1, 1962 (R. 27-A), but the unauthorized withdrawals continued through June 6, 1962 (R. 10-A). Although taxpayer testified (R. 28-A) that upon his return to New York, he informed a member of the law firm which represented Bruce Co. of the unauthorized withdrawals, he did not specify the date of such disclosure. In any event, the promissory notes and assignment were not executed until June 8, 1962, after the last of the withdrawals. (R. 17-A--19-A, 194-A.)

It is evident that not more than two of Bruce Co.'s directors were informed of the withdrawals prior to the evening of June 11, 1962, when taxpayer and his father met informally with four of the directors to explain to them what had happened. (R. 156-A--160-A.) 8/ The other board

8/ Although taxpayer testified (R. 32-A) that "I must have told six of the directors immediately about the withdrawals", the deposition of Thomas Creech, one of Bruce Co.'s directors, establishes that of the six directors to which taxpayer apparently referred, four of them had no knowledge of the withdrawals prior to the informal meeting on the evening of June 11, 1962 (R. 156-A--160-A). It is also interesting to note that Creech referred to taxpayer's disclosures and explanations at that meeting as a "selling job on the fact that what he [taxpayer] had done * * * was for the long range advantage of E.L. Bruce Company." (R. 159-A.) And, contrary to taxpayer's statement (R. 32-A) that more than half of the directors informed of his actions had agreed to approve them at the formal board meeting, Creech testified (R. 160-A) that no commitments were made by the four directors at the meeting of June 11, 1962.

members were informed of the withdrawals at the formal board meeting on June 12, 1962. At that time, the minutes of the meeting reflect that each of the directors was questioned as to his knowledge of the withdrawals, and each stated that he had not been informed by taxpayer of his plans to make the withdrawals and had "neither authorized or consented to them in any respect". (R. 84-A.)[9/]

As shown above, taxpayer's unauthorized withdrawals from Bruce Co. spanned a period of ten days, and taxpayer was in New York for at least the last six days of this period. If taxpayer truly had been concerned about the well-being of Bruce Co., it is totally unclear why he did not call a special board meeting of the Bruce Co. directors at some time between June 1 and June 6, 1962, in order to inform the board of what was happening and to seek its approval. As things worked out, however, taxpayer presented the board with a fait accompli--his margin calls had been covered, but the corporation had been deprived of nearly $2,000,000.

There are other circumstances indicating that taxpayer did not have Bruce Co.'s best interests at heart during the period of the withdrawals. For example, Thomas Creech

9/ These circumstances clearly contradict taxpayer's assertion (Br. 23), that both taxpayer and Bruce Co. recognized taxpayer's obligation to repay at the time of the withdrawals.

testified on deposition (R. 169-A, 171-A--172-A) that the funds which taxpayer misappropriated from Bruce Co. represented the proceeds of certain loans to Bruce Co. which had been negotiated by taxpayer without the knowledge of a number of the corporation's directors. Also, taxpayer pleaded guilty to a federal indictment charging him with willful failure to file with the American Stock Exchange and Securities and Exchange Commission statements indicating his beneficial ownership of Bruce Co. and changes in that beneficial ownership during the month of May, 1962. This suggests not only that taxpayer was trading his Bruce Co. stock, but that he wanted the information concerning such transactions to be withheld. Finally, it is undisputed that the margin calls which taxpayer received on May 28, 1962, were for his personal margin accounts (which were secured by his Bruce Co. stock), and for the accounts of his associates, whom he had guaranteed against loss. (R. 193-A.) The margin calls were in no way connected with Bruce Co.'s own purchases of Celotex stock.

As a final matter, it is appropriate to examine in some detail this Court's recent holding in the case of Buff v. Commissioner, 496 F. 2d 847 (1974), and its relevance to the facts in the present case. In Buff, the taxpayer had embezzled some $22,000 from his employer between January 1 and June 7, 1965. Upon the employer's discovery of the embezzlement in June of

1965, the taxpayer immediately confessed. Thereupon, at his employer's insistence, the taxpayer signed an affidavit of confession of judgment for the embezzled amount, plus interest, agreed to continue his employment, and to repay $25 per week from his pay check. He also borrowed $1,000 from a bank, paying over the proceeds from the loan to his employer. However, a month later the employer became dissatisfied with the arrangement, discharged the taxpayer, and filed the affidavit whereupon judgment was entered in his favor.

The Tax Court, relying in part on United States v. Merrill, 211 F. 2d 297 (C.A. 9, 1954), held that where there is "consensual recognition" of indebtedness within the same taxable year, formalized by a confession of judgment, such a transaction does not result in the realization of taxable gain. Accordingly, it ruled for the taxpayer. Seven judges of the Tax Court dissented from this decision.

On appeal, the Commissioner presented three arguments for reversal. First, he contended that the Merrill decision was erroneous in allowing a cash basis taxpayer to balance for tax purposes the receipt of income with a promise to repay made in the same tax period. Second, he claimed that in the case of embezzlement, the lack of consensual recognition of an obligation to repay at the time of receipt is the crucial consideration under James v.

United States, supra, rather than the presence of that recognition at the end of the pertinent accounting period. Third, it was contended that the taxpayer's confession of judgment, under the facts of the case, should be viewed as a mere sham.

This Court reversed the Tax Court's decision in Buff, finding Merrill to be distinguishable.[10/] It further agreed with the dissenting opinion of Judge Hoyt in the Tax Court, that "the judgment was not worth the paper it was written on," and determined that it "would be wholly unrealistic" to allow the taxpayer's worthless confession of judgment to balance the $22,000 taken in cash. 496 F. 2d, p. 849.

10/ In a concurring opinion, Judge Oakes argued that Merrill had been erroneously decided, and should not be given any precedential value in this Circuit. Subsequently, in the case of Quinn v. Commissioner, supra, pp. 624-625, the Seventh Circuit expressed agreement with Judge Oakes' views, and declined to apply Merrill in that Circuit.

In this context, although in the instant case the Tax Court found (R. 195-A) that the fair market value of the property assigned to Bruce Co. by taxpayer to secure his promissory notes exceeded the face amount of the notes on June 8 and June 12, 1962, we submit that by June 13, 1962, the value of that assignment, for all practical purposes, amounted to only a mere fraction of the face amount of the notes. From the entire record, it is apparent that the asset primarily relied upon by taxpayer to establish the value of the assignment consisted of a block of approximately 207,000 shares of Bruce Co. stock which he had pledged as collateral for a loan of $2,115,000 from the First National Bank of Chicago. (R. 35-A.)[11/] On June 8, 1962, that stock was selling at $21.75 per share (R. 148-A); on June 12, 1962, it reached a high of $20 per share and closed at $15.75 per share (R. 197-A). Accordingly, had the stock been sold on June 8, 1962, or

11/ Among taxpayer's remaining assets, the major portion of his Bruce Co. stock had been put up as collateral for his Celotex purchases (R. 25-A); most of his real estate was heavily mortgaged (R. 42-A, 48-A); and, as demonstrated by subsequent events, the value and ownership of taxpayer's paintings were in doubt (R. 49-A--52-A).

at its high point on June 12, 1962, taxpayer's "equity" in the stock would have been sufficient to cover the total face amount of the promissory notes. However, on June 13, 1962, after the news of taxpayer's misappropriations and flight to Brazil had been made public, Bruce Co. stock was selling at $10 to $10.50 per share just prior to its suspension from trading by the Securities and Exchange Commission. (R. 15-A.) At this price, the sale of taxpayer's shares with the Chicago National Bank would have yielded only a small amount in excess of the bank loan which had been secured by the stock.[12/] When trading of Bruce Co. stock was resumed on November 19, 1962, the closing price of the stock on that date was $8.75 per share. (R. 16-A.)

We submit that the value of the assets assigned by taxpayer properly should be measured over a reasonable period of time, beginning with June 12, 1962, the date on which Bruce Co.'s board of directors was informed of the assignment. Indeed, Mr. Field, a member of the law firm which represented Bruce Co. after June 12, 1962, testified (R. 46-A) that the matter of taxpayer's assignment was considered as "academic" until the evening of June 12, after the deal with Ruberoid had fallen through and taxpayer had fled

12/ This is supported by evidence which indicates that the block of Bruce Co. stock in question was sold in August, 1962, for $2,145,136.36. (See R. 66-A.)

to Brazil. Certainly, it would have been difficult, if not impossible, for Bruce Co. to liquidate the block of stock on June 12, 1962, and by June 13, any proceeds of such liquidation would have been totally insufficient to cover taxpayer's notes. Under these circumstances, taxpayer's assignment did not constitute a realistic balance to the misappropriated $1,953.000.[13/]

As previously noted, the only relief available to taxpayer in the present case is "to deduct from income of any year any amount repaid in such year in restitution". Mais v. Commissioner, 51 T.C. 494, 499 (1968). Taxpayer's misappropriations fall within the ambit of Section 165(c)(2) of the Internal Revenue Code of 1954 (26 U.S.C.) (a transaction entered into for profit, albeit not one arising from a trade or business), and accordingly, a deduction is allowable to taxpayer under Section 165(a) of the Code for any repayment of misappropriated funds for the taxable year in which repayment

13/ It should be noted that as of the date of taxpayer's petition to the Tax Court, Bruce Co., from about 1970 on, had received $390,145.50 as proceeds from the sale of taxpayer's assets. (R. 47-A.) This constitutes a relatively small percentage of taxpayer's total misappropriations. Of the amount received by Bruce Co., about $135,000 has been turned over to the Government pursuant to an agreement. (R. 47-A.)

is made.[14/] Rev. Rul. 65-254, 1965-2 Cum. Bull. 50.

However, in the case of a cash basis taxpayer, as here, "repayment" means actual repayment, not a mere agreement to repay, and this is true even if the agreement to repay is secured by an assignment of property. Helvering v. Price, 309 U.S. 409 (1940); Quinn v. Commissioner, 524 F. 2d 617 (C.A. 7, 1975). As stated by the Supreme Court in Helvering v. Price, supra, pp. 413-414:

> As the return was on the cash basis, there could be no deduction in the year 1932, unless the substitution of respondent's note in that year constituted a payment in cash or its equivalent. There was no cash payment and under the Eckert case the giving of the taxpayer's own note was not the equivalent of cash to entitle the taxpayer to the deduction.
>
> Respondent urges that his note was secured, but the collateral was not payment. It was given to secure respondent's promise to pay * * *.

14/ Section 165 of the Code provides in pertinent part:

> Internal Revenue Code of 1954 (26 U.S.C.):
>
> SEC. 165. LOSSES.
>
> (a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> * * *
>
> (c) Limitation on Losses of Individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to--
>
> (1) losses incurred in a trade or business;
>
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; * * *
>
> * * *

In the present case, taxpayer concedes that the mere tender of his secured notes to Bruce Co. did not constitute actual payment in 1962 to the extent of the face amount of the notes. (Br. 24.) He further concedes that Bruce Co. did not accept taxpayer's assignment as payment for its claim against taxpayer. (Br. 24.) Accordingly, taxpayer did not repay during 1962 the amounts misappropriated by him in that year, and the Tax Court correctly determined that he was not entitled to any deduction for repayment.

Having conceded that there was no repayment,[15/] taxpayer now places heavy emphasis on the point that because the Government had placed tax liens on all of his property on June 22, 1962, he was thereby prevented from making full restitution to Bruce Co. during that year. (Br. 24-29.) Having thus been "denied * * * the availability of a deduction" (Br. 26), it is argued (Br. 26-29) that the Government should not be permitted to increase taxpayer's income by tying up the assets which he could have used to repay the misappropriated funds.

We submit, however, that it is somewhat misleading to fault the Government for filing its tax liens under the circumstances of this case. Clearly, the Government's actions were motivated, at least in part, by taxpayer's own decision to flee the country. Given the fact that taxpayer was a prominent and exceedingly active member of New York's business and financial communities, and in

15/ This represents a dramatic shift in position for taxpayer, who maintained in his Tax Court brief and reply brief that he had made full repayment or restitution.

view of his potentially large tax liability, the Commissioner would have been remiss had he not moved quickly to insure that the Government's tax position would not be jeopardized.[16/]

Nor was there any indication in the evidence adduced at trial that at the time taxpayer returned from Brazil in November of 1962, he, or anyone acting in his behalf, initiated any efforts to negotiate with the Government for a release of the tax liens so that Bruce Co. could realize on taxpayer's assignment, and so that he could reduce his income by making restitution pro tanto. Rather, it was Bruce Co. which made efforts to deal with the Government on the issue of liquidating the liened assets, and finally was able to work out an agreement with the Government under which it would realize some recovery on the assignment, but whereby the Government's tax position would be protected. (R. 43-A--44-A.) While Bruce Co. may well have suffered as a result of taxpayer's actions, and its situation made no easier by reason of losing priority to the Government's tax liens, the tax law mandates the conclusion that the funds in issue constitute taxable income to the taxpayer. (The dissenters in *James*, *supra*, pp. 227-229, 252, emphasized the hardship to the victim of the taxpayer's defalcations, but this consideration

16/ It should also be noted that despite taxpayer's assertions to the effect that he did everything "in his power" to accomplish full repayment in 1962 (Br. 24), and that but for the Government's jeopardy assessments on June 22, 1962, Bruce Co. could have liquidated taxpayer's assets and obtained full repayment by the end of 1962 (Br. 27), the evidence indicates that as of

(continued)

was obviously insufficient to convince a majority of the Court to hold in favor of the taxpayer.) It bears noting in this respect that the Government's tax liens were concededly duly filed and perfected (Br. 25), while the taxpayer's prior assignment to Bruce Co. was not recorded (Br. 25; R. 42-A)[17/] because the company's counsel was unwilling to pay the filing fee demanded by the county clerk's office. Under these circumstances, the Government should not be faulted for properly acting to protect its own legitimate tax interests, and can scarcely be guilty of having improperly increased taxpayer's income for 1962 by virtue of its liens.

16/ (continued)

June 13, 1962, taxpayer's assets were of insufficient value to provide for the full repayment of his misappropriations. Moreover, the decline in the value of those assets from June 8 to June 13, 1962, was at least partially caused by taxpayer's own precipitous flight to Brazil.

17/ Bruce Co.'s counsel in effect conceded (R. 43-A) that, at least as to certain assets, the liens had "beaten us * * * quite clearly."

CONCLUSION

For the foregoing reasons, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 3rd day of December, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

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